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MONETARY POLICY AND CREDIT FLOWS

Remarks By

Andrew F. Brimmer
Member
Board of Governors of the
Federal Reserve System

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Andrew F. Brimmer*

Undoubtedly, one central question is on the minds of every banker: will there be a relaxation of monetary restraint -- once fiscal restraint takes on more of the task of fighting inflation in the United States? While I recognize the critical importance of this question, I cannot provide a definitive answer.

However, I can state my own convictions -- and preferences -- based on a careful assessment of the impact of monetary actions already taken combined with the prospective effects of the fiscal measures now before Congress -- involving higher income taxes and reduced expenditures by the Federal Government. In my personal judgment, the combination of monetary and fiscal restraint of the magnitude contemplated would allow some substitution of fiscal for monetary restraint. The key points to be resolved are these: how soon can such substitution occur and how far can it go? Here, also, the answer must be less positive than I would like to give. Yet, we can outline the major considerations which must necessarily influence the decisions of the monetary authorities. My own assessment as presented in these remarks can be summarized briefly:

- The policy of monetary restraint followed since late last year has resulted in a noticeable moderation in

* Member, Board of Governors of the Federal Reserve System.

- the growth of bank credit, and further effects are still unfolding.

- In the near-term, credit demands likely will remain strong -- despite the early adoption of higher income taxes and reduced Federal spending.

- As these new measures of fiscal restraint register their effects during the remainder of 1968 and into 1969, the total impact of both monetary and fiscal action would eventually produce more restraint than the economy would require. Thus, one can see an obvious need to relax monetary restraint in the long-run.

- On the other hand, the robust domestic inflation and the tenacious deficit in our balance of payments will obviously condition the timing and limit the extent of any relaxation in the prevailing policy of monetary restraint.

Impact of Monetary Restraint

In adopting a restrictive monetary policy late last year, the principal objective of the Federal Reserve was to counter inflationary pressures through restraint on the growth of bank credit and the money supply. An equally important aim has been to achieve this objective without generating extreme pressures in financial markets or disrupting the basic function of the economy. In this pursuit, all of the general instruments of monetary policy have been employed in a coordinated manner. The discount rate has been raised in three steps from 4 to 5-1/2 per cent. Reserve requirements have been raised by 1/2 percentage point on demand deposits above $5 million at each member bank, absorbing about $550 million of bank reserves. Open market operations, on a net basis, have absorbed bank reserves, so that the net growth in reserves since last November has resulted entirely from member banks borrowing from Federal Reserve Banks.

The impact of these actions on some of the key financial flows can be seen in Table 1.

Table 1. Annual Percentage Rates of Change in Monetary Indicators for Selected Periods

Series-Seasonally Adjusted	Year 1967	Dec. 1967 May 1968[1/]	Dec. 1967 Mar. 1968	Apr. 1968 May 1968[1/]
Total reserves	9.8	3.1	6.5	-3.7
Nonborrowed reserves	11.5	-1.7	-0.4	-4.4
Total member bank deposits	11.6	3.1	5.5	-1.5
Money supply	6.5	5.6	3.6	9.5
Time and Saving deposits	15.8	5.0	6.7	1.6
Savings accounts at thrift institutions	9.4	5.9	6.1	5.5

NOTE: Dates are inclusive.

1/ Figures for May are preliminary.

These data cast into sharp focus the considerable moderation that has occurred in credit availability since last November. Total reserves expanded at an annual rate of 3.1 per cent during the six months ending in May, compared with just under 10 per cent in 1967 as a whole. Moreover, the pressure on bank reserves has become noticeably greater in the last few months. In the April-May period, total reserves actually declined at an annual rate of 3.7 per cent -- in contrast to an expansion at a 6.5 per cent annual rate during the four months ending in March. A similar pattern is observable in the behavior of nonborrowed reserves, but the profile is sharper. Federal Reserve actions have resulted in a net decline of nonborrowed reserves at an annual rate of 1.7 per cent during the December-May months, but in April and May taken together the decline was at an annual rate of 4.4 per cent. This check in the growth of bank reserves has been achieved despite the fact that the System had to purchase over $2 billion of Government securities to cushion the reserve impact on the domestic banking system of the substantial outflow of gold.

In the six months ending in May, total member bank deposits rose at an annual rate of 3.1 per cent. This rate is just over one-quarter that recorded for the full year 1967. Even so, in the last two months, such deposits actually declined at an annual rate of 1.5 per cent. The pattern of Treasury financing has produced month-to-month fluctuations in the pace of deposit expansion, but the growth trend generally was slackening even through the end of March.

The money supply expanded at an annual rate of 3.6 per cent during the December-March period, compared with 6.5 per cent in 1967 as a whole. Beginning in April, however, the money supply has grown much more rapidly, registering a 9.5 per cent annual rate of growth in the last two months. To some extent, this spurt reflects the sharp decline in U. S. Government demand deposits in commercial banks. Member banks alone have reported a drop in these deposits from $6.4 billion in March to $3.9 billion in May. In addition, the rapid expansion in economic activity (as seen in the growth of GNP at a 10 per cent annual rate) may have generated a need for larger cash balances. But there has also been a widening mosaic of uncertainties (stemming partly from the prospect of higher Federal income taxes and urban disturbances) which apparently has induced many depositors to accumulate precautionary balances. The sharp rise in stock market activity (which has also brought noticeable processing delays) could have added further to the demand for cash balances. Looking ahead, one might expect this rapid growth of the money supply to moderate substantially after mid-year; the Treasury will have to rebuild its balances in commercial banks, and Congressional passage of the bill raising income taxes and reducing Government expenditures should remove one of the main elements of uncertainty facing the country.

The inflow of time and savings deposits at commercial banks has slowed noticeably. During the six months ending in May, the annual rate of expansion was 5.0 per cent. This was less than one-third that recorded in 1967. In April and May combined, the annual rate of expansion was 1.6 per cent. Although inflows of consumer-type time and savings deposits at weekly reporting banks were considerably improved in late May, it is too early to tell whether this trend is continuing in June. Clearly, developments in this area will have much to do with the short-term outlook for the availability of bank credit, and I shall return to this below.

Table 2. Annual Percentage Rates of Change in Commercial Bank Credit for Selected Periods

Series-Seasonally Adjusted	Year 1967	Dec. 1967 May 1968	Dec. 1967 Apr. 1968	May 1968
Total loans and investments	11.5	6.9	7.1	5.8
U.S. Government sec.	11.0	-3.6	-10.1	30.4
Other sec.	26.1	10.6	12.3	1.9
Total loans	8.2	8.7	10.4	0.5
Business loans	9.8	11.6	12.8	5.4

NOTE: Dates are inclusive.

The rate of growth and composition of bank credit have varied considerably during the current period of monetary restraint, reflecting in part the pattern of Treasury financing. As shown in Table 2, total loans and investments at commercial banks rose at an annual rate of 6.9 per cent during the six months ending in May. This increase was about three-fifths that registered in 1967 as a whole. In May alone, the annual rate of growth was 5.8 per cent. The influence of Treasury financing activities on the behavior of bank credit during this period is shown, for example, by the developments in February and March. In February when the Treasury issued a large volume of new 15-month notes, the banks substantially enlarged their holdings of Government securities, but sizable liquidation took place in March. This pattern produced a rapid increase in total loans and investments in January-February and a moderate decrease in March.

In April, the expansion in bank credit centered in loans rather than in investments. The growth in business loans was particularly striking, much of it reflecting borrowing for tax purposes. There was also heavy borrowing by sales finance companies, mainly to redeem a large volume of open market paper which corporations allowed to run off in order to meet their own tax payments. In May, the banks again absorbed a substantial amount of Government securities through participating heavily in underwriting Treasury financing. But growth in loans to businesses and finance companies fell off sharply from the high

April rate. As a result, the growth of total loans and investments eased off further to an annual rate of 5.8 per cent.

Short-Run Outlook for Bank Credit and Deposit Flows

There are indications, however, that the demand for loans may expand appreciably in the weeks ahead--while the banks may have difficulty sustaining deposit inflows. For example, business loans at large weekly reporting banks rose by $345 million during the first reporting week in June--a period in which a decline would normally be expected. This was followed during the next week by a further rise of $76 million at New York City banks; while the latter may have included some borrowing associated with corporate dividend payments, it probably did not yet reflect any appreciable amount of borrowing for meeting mid-June tax payments. Finance companies and brokers and dealers in securities also were heavy borrowers in early June.

Loan demands of both nonfinancial and financial businesses are expected to continue strong in the weeks ahead, partly for seasonal reasons. A major element in the borrowing pattern at this time of year, of course, is the payment of corporation income taxes in mid-June. These payments have been running much larger in June than in any other month. However, there probably has been less concentration of borrowing in the June tax period this year than was considered a likely possibility a short time ago. Postponement of the House vote on the tax bill until June 20 means that none of the retroactive and accelerated tax payments provided for in that bill would be due until July. As a result, corporate income tax payments made earlier this week probably were appreciably less than last year, when they totaled $9.3 billion. Moreover, there was a large volume of maturing tax anticipation bills outstanding relative to the estimated amount of tax payments.

Even though the amount of retroactive and accelerated tax payments that would be postponed until July is not large, these payments could involve a significant amount of bank borrowing. Corporations are reported to be only partially prepared for meeting these payments.

Loan demands in the weeks ahead also will be influenced by business developments. The steel producing and fabricating industries are expected to continue to accumulate inventories up to the July 31 expiration date of their wage contract. Dealer inventories of automobiles may rise further before production of 1968 models is terminated prior to the model changeover. Financing needs also will be bolstered by the renewed expansion in plant and equipment expenditures following the second quarter pause, as shown in the latest Commerce-SEC Survey. In addition, finance companies often reach their highest level of bank borrowing around midyear, when their commercial paper run-off is large and their receivables are expanding.

At the same time that banks will be facing strong loan demands, they may have to cope with a large run-off of certificates of deposits (CD's) in denominations of $100,000 and over. The prospect of such attrition would be reduced if the tax bill is passed and Treasury bill yields decline promptly. During the first two weeks of June, even though the 90-day bill yield had receded from its May peak down to the 5.65-5.70 per cent range, weekly reporting banks encountered almost continuous attrition. Given the prevailing circumstances, it would not be surprising if attrition had been held down during this period by dealer accumulation of CD inventories in anticipation of a decline in market yields. A sharp CD run-off undoubtedly occurred around the mid-June tax date, when maturities were large and presumably intended mainly for tax payments.

The further decline in bill yields that has occurred this week, apparently in anticipation of a tax increase, would serve to moderate the CD rollover problem for banks. On the other hand, recent experience suggests that outstanding CD's probably would continue to decline if bill yields were to return to the levels prevailing in early June, and any appreciable rise in yields above those levels would lead to serious attrition.

As mentioned above, consumer-type time and savings deposits at banks, in contrast to CD's, performed relatively well in May. After a substantial decline in April, these deposits at city banks turned up in early May and growth was fairly rapid in the latter part of the month. For the month as a whole, the increase about offset the April decline. Consumer savings flows also showed improvement in May at country banks -- but relatively less than at city banks. The May growth in consumer savings at all commercial banks, while down from earlier in the year, nevertheless, was reasonably rapid.

Since the improved late May performance at city banks did not continue into early June, one should be cautious about the outlook for savings inflows for the month as a whole. Moreover, substantial outflows may well occur immediately following end-of-June interest crediting as interest-sensitive funds are transferred into higher yielding market instruments.

Changing the Mix of Monetary and Fiscal Policy

The conclusion I reach from the above assessment is that -- once more fiscal restraint is put in place by the adoption of higher income taxes and reduced Federal expenditures -- there should be at least a moderate reduction in the pressure on market interest rates. But, over the next few months, even with a tax increase, the banking system could remain under considerable pressure. Although tax action would reduce the Federal Government's need to borrow during the fiscal year beginning July 1, the Treasury may still have to borrow a sizable amount during the summer months. This financing would have to depend heavily on underwriting by commercial banks.

Moreover, as indicated above, the banks would still expect strong loan demand over the next few months. This demand might coincide with a large outflow of time deposits -- from large denomination CD's in June and consumer-type time deposits in July. Thus, it remains of vital importance that Congress enact the fiscal measures now before it -- in order to reduce the pressure on market interest rates.

Once more fiscal restraint is in force, it should be possible to rely less on monetary restraint as the principal means of fighting inflation. How soon the policy mix could be changed -- and how much relaxation could be allowed -- would be conditioned by the pace of the domestic inflation and the deficit in our balance of payments. However, with passage of the tax bill, market expectations should normally moderate further increases in yields -- especially in the short-term area. If this occurs, it would clearly help financial institutions (including mutual savings banks and savings and loan associations as well as commercial banks) to maintain deposit inflows.

Taking a somewhat longer-run view, I believe there is also a case for some degree of substitution of fiscal for monetary restraint. The effects of monetary restraint (delayed and partly masked by a web of institutional relationships) are becoming increasingly evident. Flows to savings institutions have slowed substantially. The number of new housing starts has averaged just under an annual rate of 1.5 million units for a number of months (despite the sharp jump in April). In view of the slower inflow of funds at savings institutions, a decline in housing starts seems in prospect. As the effects of monetary restraint spread to other sectors, there should be further moderation in the pace of domestic economic activity in the closing months of 1968 and in the first half of 1969.

Such moderation in activity is exactly what the economy needs if we are to make any headway in checking the current inflation. However, we should also keep in mind that fiscal restraint of the magnitude now being considered in Congress -- even taken alone -- would have a sizable impact on the economy in the first half of 1969. Previously approved -- but delayed -- social security taxes will also become effective early next year. Thus, the cumulative impact of the present degree of monetary restraint <u>plus</u> the restraint to be generated by the new fiscal measures may turn out to be more than the economy requires as the year 1969 progresses.

Consequently, a high premium must be placed on the sensitivity and flexibility of monetary management in the months ahead.